INITIAL STATEMENT OF REASONS
FOR RULE CHANGES UNDER THE
CORPORATE SECURITIES LAW OF 1968

As required by Section 11346.2 of the Government Code, the California Corporations Commissioner ("Commissioner") sets forth below the reasons for the proposed amendments to Sections 260.140.8, 260.140.41, 260.140.42, 260.140.45, and 260.140.46 of Title 10, California Code of Regulations, of the Corporate Securities Law of 1968 (the "CSL") relating to compensatory benefit plans.

BACKGROUND

The Commissioner regulates the offer and sale of securities in California under the CSL, commencing with Corporations Code Section 25000. It is unlawful for any person to offer or sell in this state any security in an issuer transaction unless such sale has been qualified by the Commissioner or unless such security or transaction is exempt or not subject to qualification. (See Corporations Code Section 25110.)

Under Corporations Code Section 25140, the Commissioner may refuse to qualify an issuance of securities unless the Commissioner finds that the proposed issuance of securities is "fair, just, and equitable." The Commissioner has adopted qualification guidelines for various types of offerings of securities, including securities issued pursuant to compensatory benefit plans. (See *10 C.C.R.* 260.140.41-42 and 260.140.45-46, hereinafter referred to as the "Compensatory Plan Regulations.") The guidelines are general in nature and such standards are not intended to preclude the application of more liberal or more stringent standards if justified by the circumstances. (See *10 C.C.R.* 260.140.)

In addition to providing guidance for applications submitted to the Commissioner for qualification, the Compensatory Plan Regulations play a separate role with respect to an exemption from qualification. Under Corporations Code Section 25102(o), the offer or sale of any security issued by a corporation or limited liability company pursuant to a compensatory benefit plan is exempt provided the issuance is exempt from federal registration pursuant to Rule 701 ("Rule 701") of the Securities Act of 1933, as amended (17 C.F.R. 230.701), the terms of such plan comply with the Compensatory Plan Regulations, and a notice filing and fee is provided to the Department of Corporations (the "Department"). Offers and sales exempt under Corporations Code Section 25102(o) are deemed to be part of a single, discrete offering and not subject to integration with any other offer or sales, whether qualified, exempt from qualification, or not subject to qualification.

In 1999, the Commissioner proposed amendments to Sections 260.140.41, 260.140.42 and 260.140.45 (published in California Regulatory Law Bulletin 99, No. 01, p. 26, hereinafter referred to as the "1999 Rulemaking Project"). The 1999 Rulemaking

Project proposed to repeal certain provisions of the Compensatory Plan Regulations, including conditions related to the exercise price, vesting schedule, and repurchase rights. Final regulations under the 1999 Rulemaking Project, however, were never adopted.

In 2001, the Commissioner proposed amendments to the Compensatory Plan Regulations to implement the statutory change enacted by SB 1837 (Chap. 705, Stats. 2000) (hereinafter referred to as the "2001 Rulemaking Project"). SB 1837 extended the exemption in Corporations Code Section 25012(o) to include securities issued by limited liability companies. During the comment period for the 2001 Rulemaking Project, the Commissioner received requests that the Compensatory Plan Regulations be amended in the manner previously proposed in the 1999 Rulemaking Project. Since such suggestions were outside the scope of the 2001 Rulemaking Project, they were not acted upon.

Nonetheless, in February 2002, the Commissioner issued an invitation to comment on the Compensatory Plan Regulations ("2002 Invitation for Comment") in light of the continuing interest of stakeholders in the 1999 Rulemaking Project. The Department received a number of comments as result of its invitation, but has taken no action since with respect to the Compensatory Plan Regulations.

The Compensatory Plan Regulations are generally not applicable to compensatory plans offered by publicly-traded companies listed on the major exchanges. Corporations Code Section 25100(o) exempts from qualification with the Commissioner any warrant or right to subscribe to securities listed on the New York Stock Exchange, the American Stock Exchange, the Nasdaq Global Market, and the Nasdaq Global Select Market. (See also Commissioner's Release 27-C (rev. Mar. 9, 1992) and Release 87-C (Oct. 8, 1993).)

The Commissioner believes that compensatory benefit plans play an important and positive role in the development of businesses, especially newer and emerging businesses that seek to utilize capital to grow rather than for individual compensation. These plans can provide the opportunity for employees, officers, directors, consultants and others to participate in the potential future growth of the company where they work. Options, when awarded and exercised in a lawful and proper manner, can serve as a powerful incentive for employees to enhance business growth and create shareholder value.

The Commissioner is unaware of any other state that imposes requirements similar to the Compensatory Plan Regulations. The Commissioner has concerns that the Compensatory Plan Regulations are inconsistent with the regulatory approach taken by the other states and the federal securities laws, can impose a burden on businesses seeking to create jobs and expand operations in California, and restrict the ability of California residents from participating in compensatory benefit plans without providing commensurate investor protection in return. See Corporations Code Section

25612.5(b)(1) (prescribing rules with a view to achieving maximum uniformity of registration statements, applications, and reports wherever practicable).

Accordingly, the Commissioner has determined that the standards adopted in Sections 260.140.8, 260.140.41, 260.140.42, 260.140.45 and 260.140.46 should be amended.

Section 260.140.8

Section 260.140.8 provides guidelines on restrictions on transfer, including rights of first refusal and the option of the issuer or other holders to repurchase securities. Section 260.140.8 is being amended to include the former provisions of Sections 260.140.41(k) and 260.140.42(h). As a result, Rule 701 plans or agreements that intend to utilize the exemption in Corporations Code Section 25102(o) will no longer be subject to restrictions on repurchase rights. By removing this requirement for Rule 701 plans and agreements, the Commissioner believes that this will result in more uniform regulation of such plans and agreements on a national basis. However, compensatory benefit plans or agreements submitted to the Commissioner for qualification under the fair, just and equitable standard would remain subject to the guidelines.

Section 260.140.41

Section 260.140.41 provides that the issuance of securities to employees, directors, managers or consultants under an option plan must meet specified conditions. The section heading has been renamed because it is no longer limited only to employees, directors, managers and consultants.

The introductory clause of Section 260.140.41 is being amended to be consistent with the scope of eligible persons in Rule 701. The introductory clause also clarifies that this section only applies to those offerings made for compensatory purposes (as opposed to capital raising purposes).

Subsection (a) is being amended to delete the reference to a percentage calculation found in Section 260.140.45. (Section 260.140.45 is being amended in this rulemaking project not to apply to any offering that complies with all conditions of Rule 701.) As amended, the total number of securities that may be issued by a plan may be expressed as a specific number or as a percentage. This will allow companies greater flexibility in setting the total number of securities that may be issued under the plan.

Subsection (b) is being repealed. This subsection requires that the exercise price of the securities may generally not be less than 85% of the fair value of at the time the option is granted. By repealing subsection (b), a company and its option grantees will have flexibility to determine the appropriate exercise price of the securities. The Commissioner observes that all option grants remain subject to the exercise of fiduciary duties by the directors or managers and that, as part of such duties, the directors or managers would have to consider any adverse tax or accounting consequences of

issuing below-market grants. In addition, the proposed changes would not prohibit a company from including a minimum price limitation if it so desires.

Subsection (f) is being repealed. This subsection requires that a vesting rate of at least 20% per year over five years from the option grant date. By repealing this subsection, a company and its option grantee will be able to determine an exercise schedule that meets the needs of all parties. The strict linear approach currently set forth in subsection (f) would not permit the use of targeted incentives and performance-based vesting for non-management employees. In the absence of such flexibility, it is possible that such non-management employees may be excluded from sharing in any option grants with senior management.

Subsection (g) is being amended to clarify that the regulation does not require the extension of the exercise period past the option exercise date. For example, if an option grantee held an option with an exercise period of 10 years and died one month prior to the expiration date, the option must be exercised within one month.

Subsection (h) is being amended to clarify that the authority to grant any options under a plan or agreement expires within 10 years from the date the plan or agreement is adopted or approved by the issuer's security holders, whichever is earlier. The plan itself does not need to terminate after 10 years. For example, since an option granted in the ninth year of a plan's existence can have an exercise period of up to ten years, the plan would need to exist until at least the nineteenth year. Furthermore, confidentiality or arbitration or vesting schedules may need to remain in place past the end of the 10-year period.

Subsection (i) is being amended to clarify that the guideline may be satisfied by receiving securityholder approval prior to the grant of any options in this state. Under the existing guidelines, a plan or agreement must be approved within 12 months of adoption or entering into. This requirement has created some issues for out-of-state companies seeking the exemption provided by Corporations Code Section 25102(o), especially where it has an existing plan and has expanded (through acquisition or otherwise) to hire persons in California. The amendments provide flexibility as a company may now obtain securityholder approval more than 12 months after adoption of a plan or entering into an agreement, but only if such approval is received prior to the granting of any options thereunder in California.

Subsection (i) is further being amended to permit foreign private issuers, as defined by Rule 3b-4 of the Securities Exchange Act of 1934, as amended (17 C.F.R. 240.3b-4), to utilize the exemption set forth in Corporations Code Section 25102(o). Obtaining approval of security holders can be a costly and burdensome effort, especially for foreign companies that may have been organized under laws very different from U.S. corporate laws. The proposed amendment would permit foreign private issuers to grant options and issue securities to a minimal amount of persons in this state without having to obtain approval of their security holders. The Commissioner has selected 35 persons based on similar requirements found in subdivisions (f) and (h)

of Corporations Code Section 25102 as well as Rule 506 under the Securities Act of 1933, as amended (17 C.F.R. 230.506); however, unlike the other provisions, there will be no exclusion of any person (e.g., accredited investors) from the total number.

Subsection (k) is being moved to Section 260.140.8. As a result, plans or agreements that intend to utilize the exemption in Corporations Code Section 25102(o) will no longer be subject to restrictions on repurchase rights. By placing such restrictions in Section 260.140.8, plans or agreements submitted to the Commissioner for qualification under the fair, just and equitable standard remain subject to the guidelines. By removing this requirement for Rule 701 plans and agreements, the Commissioner believes that this will result in more uniform regulation of such plans and agreements on a national basis. Since the restrictions in current subsection (h) excludes officers, directors, managers and consultants, the unintended consequence may be that subsection (h) prevents non-management employees from sharing in any potential equity gains if companies were to avoid issuing options to non-management employees due to regulatory limitations.

In determining any repurchase price, the issuer may have a bargaining advantage due to superior information. The Commissioner reiterates that Corporations Code Section 25401 requires the disclosure of all material information to the grantee during the course of negotiating the repurchase price (i.e., disclose or refrain from engaging in the transaction) and the failure to disclose can result in administrative, civil, and criminal liability.

Subsection (l) is being repealed. Current subsection (l) requires that voting stock and similar equity securities comply with Section 260.140.1. Because Section 260.140.1 will continue to apply to any application for qualification of any compensatory benefit plan, repeal of subsection (l) will only affect Rule 701 offerings. By removing this requirement for Rule 701 plans and agreements, the Commissioner believes that this will result in more uniform regulation of such plans and agreements on a national basis.

Section 260.140.42

Section 260.140.42 provides that securities sold to employees, directors, managers or consultants under a purchase plan must be issued pursuant to specified conditions. The section heading has been renamed because it is no longer limited only to employees, directors, managers and consultants and bonus plans (where recipients receive securities without any cash payment) are also covered by the section.

The introductory clause of Section 260.140.42 is being amended to be consistent with the scope of eligible persons in Rule 701. The introductory clause also clarifies that this section only applies to those offerings made for compensatory purposes (as opposed to capital raising purposes).

Subsection (a) is being amended to delete the reference to a percentage calculation found in Section 260.140.45. (Section 260.140.45 is being amended in this rulemaking project to not apply to any offering that complies will all conditions of Rule 701.) As amended, the total number of securities that may be issued by a plan may be expressed as a specific number or as a percentage. This will allow companies greater flexibility in setting the total number of securities that may be issued under the plan.

Subsection (b) is being repealed. This subsection requires that the securities have a specified purchase price as set forth in the rule. By repealing subsection (b), a company and its eligible recipients will have flexibility to determine the appropriate purchase price of the securities. The Commissioner notes that the minimum purchase price requirement in current subsection (b) created some confusion as to whether a company could issue bonuses in the form of securities. The Commissioner observes that all purchase plans and bonus plans remain subject to the exercise of fiduciary duties by the directors or managers. In addition, the proposed changes would not prohibit a company from including a minimum price limitation if it so desires.

Subsections (c) and (d) are being amended to conform to the types of persons now eligible to purchase securities under this section.

Subsection (e) is being amended to clarify that the authority to issue securities under a plan or agreement expires within 10 years from the date the plan or agreement is adopted or approved by the issuer's security holders, whichever is earlier. The plan itself does not need to terminate after 10 years. For example, confidentiality or arbitration or vesting schedules may need to remain in place after past the end of the 10-year period.

Subsection (f) is being amended to clarify that the guideline may be satisfied by receiving securityholder approval prior to the issuance of any securities in this state. Under the existing guidelines, a plan or agreement must be approved within 12 months of adoption or entering into. This requirement has created some issues for out-of-state companies seeking the exemption provided by Corporations Code Section 25102(o), especially where it has an existing plan and has expanded (through acquisition or otherwise) to hire persons in California. The amendments provide flexibility as a company may now obtain securityholder approval more than 12 months after adoption of a plan or entering into an agreement, but only if such approval is received prior to the issuance of any securities thereunder in California.

Subsection (i) is further being amended to permit foreign private issuers, as defined by Rule 3b-4 of the Securities Exchange Act of 1934, as amended (17 C.F.R. 240.3b-4), to utilize the exemption set forth in Corporations Code Section 25102(o). Obtaining approval of security holders can be a costly and burdensome effort, especially for foreign companies that may have been organized under laws very different from U.S. corporate laws. The proposed amendment would permit foreign private issuers to grant options and issue securities to a minimal amount of persons in this state without having to obtain approval of their security holders. The Commissioner

has selected 35 persons based on similar requirements found in subdivisions (f) and (h) of Corporations Code Section 25102 as well as Rule 506 under the Securities Act of 1933, as amended (17 C.F.R. 230.506); however, unlike the other provisions, there will be no exclusion of any person (e.g., accredited investors) from the total number.

Subsection (h) is being moved to Section 260.140.8. As a result, plans or agreements that intend to utilize the exemption in Corporations Code Section 25102(o) will no longer be subject to restrictions on repurchase rights. By placing such restrictions in Section 260.140.8, plans or agreements submitted to the Commissioner for qualification under the fair, just and equitable standard remain subject to the guidelines. By removing this requirement for Rule 701 plans and agreements, the Commissioner believes that this will result in more uniform regulation of such plans and agreements on a national basis. Since the restrictions in current subsection (h) excludes officers, directors, managers and consultants, the unintended consequence may be that subsection (h) prevents non-management employees from sharing in any potential equity gains if companies were to avoid issuing securities to non-management employees due to regulatory limitations.

In determining any repurchase price, the issuer may have a bargaining advantage due to superior information. The Commissioner reiterates that Corporations Code Section 25401 requires the disclosure of all material information to the grantee during the course of negotiating the repurchase price (i.e., disclose or refrain from engaging in the transaction) and the failure to disclose can result in administrative, civil, and criminal liability.

Subsection (i) is being repealed. Current subsection (i) requires that voting stock and similar equity securities comply with Section 260.140.1. Because Section 260.140.1 will continue to apply to any application for qualification of any compensatory benefit plan, repeal of subsection (i) will only affect Rule 701 offerings. By removing this requirement for Rule 701 plans and agreements, the Commissioner believes that this will result in more uniform regulation of such plans and agreements on a national basis.

Section 260.140.45

Section 260.140.45 is being amended to exclude plans that comply with all conditions of Rule 701. Rule 701(d) limits on the aggregate sales price or amount of securities sold in reliance of such rule within any 12-month period to the greater of $1 million, 15% of the total assets of the issuer, or 15% of the outstanding amount of the class of securities being offered. The Commissioner concludes that the sufficiency of federal regulation, as well as the interest in uniform regulation of national offerings, justifies exempting Rule 701 offerings from Section 260.140.45.

Section 260.140.46

Section 260.140.46 is being amended to exclude plans that comply with all conditions of Rule 701. Rule 701(e) requires disclosure, including financial statement disclosure under certain circumstances. The Commissioner concludes that the sufficiency of federal regulation, as well as the interest in uniform regulation of national offerings, justifies exempting Rule 701 offerings from Section 260.140.46.

ECONOMIC IMPACT GOVERNMENT CODE SECTION 11346.2(b)(4)

The Department has made an initial determination that the proposed regulations will not have a significant adverse economic impact on business.

FISCAL IMPACT

Cost to Local Agencies and School Districts required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of the Government Code: None.

No other nondiscriminatory cost or savings are imposed on local agencies.

DETERMINATIONS

The Commissioner has determined that the proposed regulatory action does not impose a mandate on local agencies or school districts, which require reimbursement pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.

TECHNICAL STUDIES RELIED UPON

The Department did not rely upon any technical, theoretical, or empirical study, reports, or other similar document in proposing the adoption of this regulation.

ALTERNATIVES CONSIDERED

No alternative considered by the Department would be more effective in carrying out the purpose for which the regulation is proposed or would be as effective and less burdensome to affected private persons or would lessen any adverse impact on small businesses.